Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-845-98
TGMcQueeney

date: FEB 1 1 1999

to: Chief, Quality Measurement Branch, Brooklyn District
ATTN: Steven Townsend, Group Manager 1207
R.A. Florence Krein

from: District Counsel, Brooklyn

subject: [redacted]/[redacted] [redacted] ([redacted]); [redacted] ([redacted])

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ISSUE

Whether [redacted] progress payments received by [redacted] road construction partnerships which report income under the completed contract method[1] should be reflected as an increase in partners' liabilities under I.R.C. § 752, a nontaxable event, or are unrealized receivables under I.R.C. § 751(c)? If unrealized receivables under I.R.C. § 751(c), should the progress payments be treated as advances, where the amounts in excess of adjusted basis are deemed current distributions made on the last day of the

[1]Our office was not asked to evaluate whether the subsection (e) exception to the I.R.C. § 460(a) Special Rules for long-term contracts requirement that percentage of completion method be used was applicable. Further, the file does not include sufficient facts to make such determination. As such, this memorandum is based on the conclusion that the completed contract method is appropriate and does not include an analysis of I.R.C. § 460.

partnership taxable year with respect to such partner under Regulation § 1.731-1(a)(i) and (ii) and are taxed at capital gain rates under Regulation § 1.731-1(a)(3)?

CONCLUSION

The [redacted] progress payments received by [redacted] road construction partnerships which report income under the completed contract method are unrealized receivables under I.R.C. § 751(c). The progress payments should be treated as advances, where the amounts in excess of adjusted basis are deemed current distributions made on the last day of the partnership taxable year with respect to such partner under Regulation § 1.731-1(a)(i) and (ii) and should be taxed at capital gain rates under Regulation § 1.731-1(a)(3). Since the advances were not a result of a sale or exchange of an interest in the partnership, such amounts in excess of the adjusted basis are not taxed at ordinary income rates until the year of completion or final disposition under I.R.C. § 751. Revenue Rulings 73-301, 79-51 and 81-241 should be followed.

FACTS

The facts, as we understand them to be, are as follows: [redacted] ([redacted]) [redacted] ([redacted]) are [redacted] partnerships involved in road construction which report income under the completed contract method. The [redacted] partners of [redacted] partnerships are 1120S corporations; the shareholders of which are individuals.

On or about [redacted], [redacted] partnerships entered into road construction contracts with the State of New York Department of Transportation to provide services through [redacted]. A copy of Contract No. [redacted] ([redacted] is in our file. Under the contracts, the State of New York Department of Transportation made progress payments to the [redacted] partnerships in [redacted]. The contracts were not completed in [redacted] and as such, the partnerships did not report [redacted] gross income related to such contracts.

For [redacted], [redacted] ([redacted]) [redacted] ([redacted]) reflected the progress payments as other liabilities in the respective amounts of $[redacted] (Other Liabilities - Billings in excess of costs on uncompleted jobs) and $[redacted] (Other Liabilities - Deferred Revenues). During [redacted], [redacted] ([redacted]) [redacted] ([redacted]) made distributions to the partners in the respective amounts of $[redacted] and $[redacted]. [redacted] partnerships were owned by [redacted] partners who were 1120S

Corporations. The 1120S Corporations treated the distributions as nontaxable.

It is our understanding that the [redacted] K-1s for the [redacted]% partners of [redacted]. [redacted] ([redacted]) reflected the following: partner's share of other liabilities of $[redacted] ([redacted]% of Other Liabilities - Billings in excess of costs on uncompleted jobs of $[redacted]; partnership income of ($[redacted]); distributions of $[redacted] ([redacted]% of $[redacted] distribution); and negative capital accounts of $[redacted] (comprised of partnership income of ($[redacted]) and distributions of $[redacted]).

It is our understanding that the [redacted] K-1s for the [redacted]% partners of [redacted]. [redacted] ([redacted]) reflected the following: Other Liabilities of $[redacted] ([redacted]% of $[redacted] amount comprised of accounts payable of $[redacted], other liabilities - accrued expenses, payroll taxes, and loans payable of $[redacted], and other liabilities - deferred revenues of $[redacted]); distributions of $[redacted] ([redacted]% of $[redacted] distribution) partnership income of ($[redacted]); and negative capital accounts of $[redacted]. Our office does not know what the opening capital account amounts were in order to determine if the closing negative capital account amounts are correct.

The partnerships assert that since the progress payments are allegedly restricted and are subject to final acceptance and final payment which may result in the return of monies paid, the partnerships' reporting of the progress payments as increases in partnership liabilities was proper under I.R.C. § 752(a).

Contract No. [redacted] ([redacted]) includes the following sections which the partnerships point to as supporting their determination that the progress payments are partnership liabilities: Article 7. Payment of Estimates; Article 9. Final Acceptance of Work; and Article 10. Final Payment. Also included in the file is a copy of New York State's Department of Transportation Standard Specifications, including Section 109, Measurement and Payment.

Article 7. Payment of Estimates provides, in pertinent part, that as the work progresses in accordance with the contract and in a manner that is satisfactory to the State, the State hereby agrees to make payments to the Contractor therefor, based upon the proposal attached hereto[2] and made a part hereof, as follows: The State shall once in each month and on such days as it may fix, make an estimate of the quantity of work done and of material which has actually been put in place in accordance with the terms and conditions of the contract, during the preceding month, and compute the value thereof and pay to the contractor the moneys due as provided in subdivision 7 of Section 38 of the Highway Law.[3]

Article 9. Final Acceptance of Work provides: When, in the opinion of the Regional Director, a Contractor has fully performed the work under the contract, the Regional Director shall recommend to the Commissioner of Transportation the acceptance of the work so completed. If the Commissioner accepts the recommendation of the Regional Director, he shall thereupon by letter notify the Contractor of such acceptance, and copies of such acceptance shall be sent to other interested parties.

Final acceptance shall be final and conclusive except for defects not readily ascertainable by the Department, actual or constructive, fraud, gross mistakes amounting to fraud or other errors which the Contractor knew or should have known about as well as the Department's rights under any warranty or guarantee. Final acceptance may be revoked by the Department at any time prior to the issuance of the final check by the Comptroller upon the Department's discovery of such defects, mistakes, fraud or errors in the work.

Article 10. Final Payment provides: After the final acceptance of the work, the Engineer shall prepare a final agreement of the work performed and the materials placed and shall compute the value of such work and materials under and according to the terms of the contract. This agreement shall be certified, as to its correctness, by the Engineer. Upon approval of such final agreement by the Regional Director, it shall be submitted to the Commissioner for final approval. The right, however, is hereby reserved to the Commissioner to reject the whole or any portion of

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[2] A copy of the progress payment proposal attached to Contract No. [redacted] ([redacted]) was not provided to our office.

[3] Subdivision 7 of Section 38 of New York Highway Law provides for a retention of (a) 20% where a performance bond is dispensed with or (b) 5% where a performance bond is given, of the progress payments until the contract is completed.

the final agreement, should the said certificate of the Engineer be found or known to be inconsistent with the terms of the agreement or otherwise improperly given. All certificates upon which partial payments may have been made being merely estimates, shall be subject to correction in the final certificate or final agreement.

Section 109 Measurement and Payment contains, in pertinent part, the following subsections: -02 Final Additions or Deductions; -03 Payments on Contract; and -11 Final Agreement. Section 109-02 Final Additions or Deductions provides: Upon the completion of the required work as shown in the plans and specifications, should the final estimate of quantities show either an increase or decrease from the approximate estimate of quantities, then such valuations will be computed at the unit prices and a final agreement will be made respectively adding or deducting this amount from the gross sum bid as modified by Orders on Contract.

Subsection 109-03 Payments on Contract provides: Payments to the Contractor for work satisfactorily performed will be made monthly upon the percentage basis prescribed by Subdivision 7 § 38 of the Highway Law. ... The attention of persons intending to make proposals is specifically called to the provisions of Section 70 and 71 of the Lien Law and Section 1302-C of the Penal Law that apply to funds being received by a Contractor for a public improvement. These provisions declare that the funds received by the Contractor shall constitute trust funds in the hands of the Contractor and shall be applied first to the payment of certain claims. ...

Subsection 109-11 Final Agreement provides: The final agreement will not be drawn and finalized until all work required under the contract has been satisfactorily completed, all claims presented and all accounts for extra work and materials have been rendered, considered, and if agreed to, made a part of such final agreement. Work remaining to be accomplished under an uncompleted work agreement, shall be considered as completed work for the purpose of the final agreement.

The Commissioner, or his designee, will approve a final agreement as prepared and approved by the Regional Director, less any and all deductions authorized to be made by the Commissioner under the contract. Payment pursuant to such final agreement less any deductions authorized to be made by the Comptroller shall constitute the final payment to the Contractor.

There are no provisions in the Contract or the Standard Specifications which state that [redacted]. [redacted] ([redacted]) and [redacted] ([redacted]) are obligated to perform additional services to retain the progress payments received or to return the progress payments received in the event of noncompliance or default.

ANALYSIS

At issue is whether the [redacted] progress payments received by [redacted]. [redacted], [redacted] ([redacted]) [redacted] ([redacted]), two road construction partnerships which report income under the completed contract method, should be reflected as an increase in partners' liabilities under I.R.C. § 752, a nontaxable event, or are unrealized receivables under I.R.C. § 751(c), the distributions of which are deemed taxable events under I.R.C. §§ 731(a)(1) and 751(b) and Revenue Ruling 73-301.

Regulation § 1.451-3(d)(1) provides that under the completed contract method, gross income derived from long-term contracts must be reported by including the gross contract price of each contract in gross income for the taxable year in which such contract is completed. All costs properly allocable to a long-term contract must be deducted from gross income for the taxable year in which the contract is completed. Regulation § 1.451-3(b)(2)(i)(A) provides, that a long-term contract shall not be considered "completed" until final completion and acceptance have occurred.

For [redacted], [redacted] ([redacted]) [redacted] ([redacted]) reflected the progress payments received as other liabilities in the respective amounts of $[redacted] (Other Liabilities - Billings in excess of costs on uncompleted jobs) and $[redacted] (Other Liabilities - Deferred Revenues). The partnerships assert that since the progress payments are allegedly restricted and are subject to final acceptance and final payment which may result in return of monies paid, the partnerships' reporting of the progress payments as an increase in partnership liabilities was proper under I.R.C. § 752(a).

The following analysis supports the conclusion that the [redacted] progress payments were not liabilities due to the contingent nature of repayment under I.R.C. § 752(a) and Regulation § 1.752-2. The progress payments should be treated as unrealized receivables under I.R.C. § 751(c). The progress payments should be treated as advances, where the amounts in excess of adjusted basis are deemed current distributions made on the last day of the partnership taxable year with respect to such partner under Regulation § 1.731-

1(a)(i) and (ii) and should be taxed at capital gain rates under Regulation § 1.731-1(a)(3). Since the advances were not a result of a sale or exchange of an interest in the partnership, such amounts in excess of the adjusted basis are not taxed at ordinary income rates until the year of completion or final disposition under I.R.C. § 751. Revenue Rulings 73-301, 79-51 and 81-241 should be followed.

I.R.C. § 752(a) provides that any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

Liabilities can be classified as recourse or nonrecourse. Black's Law Dictionary 1275 (6th ed. 1990) defines "Recourse" as "To recur. The right of a holder of a negotiable instrument to recover against a party secondarily liable, e.g., prior endorser or guarantor. Therefore, if a prior endorser signs without recourse, he exempts himself from liability for payment, but not from all warranties. U.C.C. § 3-414(1)." "Recourse loan" is defined as "Loan on which an endorser or guarantor is liable in event of default of borrower." Id.

Regulation § 1.752-2 Partner's share of recourse liabilities subsection (b)(4) entitled Obligation to make a payment - Contingent obligations provides: A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs.

Black's Law Dictionary 1057 (6th ed. 1990) defines "Nonrecourse" as "Status of person who holds an instrument which gives him no legal right against prior endorsers or the drawer to compel payment if the instrument is dishonored." "Nonrecourse debt" is defined as "Debt secured by the property that it is used to purchase. The purchaser of the property is not personally liable for the debt upon default. Rather, the creditor's recourse is to repossess the related property. Nonrecourse debt generally does not increase the purchaser's at-risk amount." Id. "Nonrecourse loan" is defined as "Type of security loan which bars the lender from action against other assets of the borrower if the security value of the specified collateral for the loan falls below the amount required to repay the loan." Id.

The Tax Court in Green v. Commissioner, T.C. Memo. 1989-436 stated that it would not include in basis a purported nonrecourse liability if it lacks economic substance or is too contingent to be treated as valid debt for tax purposes. The Court further stated that in determining whether a purported nonrecourse liability lacks economic substance or is too contingent or speculative to be treated as valid debt for Federal tax purposes, the courts have used various approaches. One line of cases looks at the fair market value of the property in relation to the stated purchase price or the principal amount of the indebtedness. This line of cases treats a nonrecourse obligation as a valid debt only if the acquired property reasonably secures payment of the obligation. Where the nonrecourse obligation is not adequately secured, a purchaser would acquire no equity in the property and therefore would have no economic incentive to pay the note. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), aff'g 64 T.C. 752 (1975); see also Waddell v. Commissioner, 841 F.2d 264 (9th Cir. 1988), aff'g 86 T.C. 848 (1986). The other major approach holds that an obligation, even if recourse, will not be treated as a true debt where payment, according to its terms, is too contingent or speculative. See Denver & Rio Grande Western R.R. Co. v. U.S., 505 F.2d 1266 (Ct. Cl. 1974); Lemery v. Commissioner, 52 T.C. 367 (1969), aff'd per curiam on another issue, 451 F.2d 173 (9th Cir. 1971).

The First Circuit Court in Brountas v. Commissioner, 692 F.2d 152 (1982), determined that an accrual basis partnership could not accrue the future obligation to pay money represented by a nonrecourse note that it issued as partial payment for oil well development where the notes were unsecured and would be paid only if there was production from the wells. Such loan was too uncertain and indefinite an obligation to be treated as a partnership liability under I.R.C. § 752(a) or as a prepaid production payment.

Based on the foregoing analysis, the [redacted] progress payments are not liabilities within I.R.C. § 752(a) and Regulation § 1.752-2.

Revenue Ruling 73-301 provides, in part, that an unrestricted progress payment received by a partnership, reporting its income on the completed contract method, during its performance on a two-year construction contract did not constitute a partnership liability or add to the partners' interests within the meaning of section 752(a) of the Code. The progress payment was deemed unrestricted since under the contract, the partnership had performed all the services required in order to be entitled to receive the progress payment and there was no obligation to return the payment or perform any additional services in order to retain it. The progress payment constituted an unrealizable receivable within the meaning of I.R.C. § 751(c).

I.R.C. § 751(a) provides that the amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to (1) unrealized receivables of the partnership, or (2) inventory items of the partnership, shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

I.R.C. § 751(c) provides that the term "unrealizable receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset; or (2) services rendered, or to be rendered. With regard to services rendered, or to be rendered, Regulation § 1.751-1(c)(1)(ii) provides that the rights to payment must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes ... rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

The partnerships have asserted that Revenue Ruling 73-301 does not apply to their facts since the progress payments were restricted and there may be an obligation to return the progress payments or perform any additional services to retain the payments received. In support of their position, the partnerships point to Articles 9 and 10 of the Contract which address final acceptance of work and final payment, respectively, and Section 109-11 of New York State's Department of Transportation Standard Specifications which addresses final agreement.

The partnerships fail to reconcile the provisions in Article 7 of the Contract and Section 109-03 of the New York State's Department of Transportation Standard Specifications which address the making of progress payments to their position that the progress payments are restricted. Both provisions provide that the progress payments are made as the work progresses in accordance with the contract and in a manner that is satisfactory to the State. Prior to payment, the State can review the work to determine if it is satisfactory and the amount of the progress payment is appropriate. Article 7 further states that the progress payments are based on estimates of the quantity of the work done and of material which has actually been put in place during the preceding month. As such, the calculation of the progress payment is based upon prior month activity and the approval of the State. Further, subdivision 7 of Section 38 of New York Highway Law provides for a retention of (a) 20% where a performance bond is dispensed with or (b) 5% where a performance bond is given, of the progress payments until the contract is completed. As noted above, our office does not have a copy of the progress payment proposal which may or may not address a retention percentage. If a percentage of the progress payments was retained, then such amounts could be used to rectify any corrections or adjustments to the final acceptance and final payment amounts. In addition, the provisions cited by the partnerships, Article 9 and 10 and Standard Specifications Section 109-11, support the conclusion that any correction or adjustments to the progress payments/contract price will be considered in the final acceptance and final payment. Lastly, there are no provisions in the Contract or the Standard Specifications which state that [redacted] ([redacted]) [redacted] ([redacted]) are obligated to perform additional services to retain the progress payments received or to return the progress payments received in the event of noncompliance or default.

Based on the facts and the foregoing legal analysis, it is our position that the progress payments received by [redacted] ([redacted]) [redacted] ([redacted]) are not liabilities under I.R.C. § 752(a). The partnerships' obligation to return the [redacted] progress payments was contingent within the meaning of Regulation § 1.752-2, and as such, should not be treated as a liability. Further, it is our position that the [redacted] progress payments are unrealized receivables under I.R.C. § 751(c), and should be treated as advances, where the amounts in excess of adjusted basis are deemed current distributions made on the last day of the partnership taxable year with respect to such partner under Regulation § 1.731-1(a)(i) and (ii) and should be taxed at capital gain rates under Regulation § 1.731-1(a)(3). Since the advances were not a result of a sale or exchange of an interest in the partnership, such amounts in excess of the adjusted basis are not taxed at ordinary income rates until the year of completion or final disposition under I.R.C. § 751.

Revenue Rulings 79-51 and 81-241 both support the determination of Revenue Ruling 73-301 that progress payments for a partnership using the completed contract method of accounting are deemed unrealizable receivables under I.R.C. § 751(c).

Revenue Ruling 79-51 addressed the federal income tax consequences to a partner of a sale of the partner's entire interest in a partnership using the completed contract method of accounting for its long-term contracts and having an uncompleted long-term contract. The Revenue Ruling determined that the amounts earned or to be earned under the uncompleted long-term construction contract were unrealized receivables within the meaning of I.R.C. § 751(c).

The distinction presented by [redacted] ([redacted] and [redacted] ([redacted]) of whether the progress payments were restricted or unrestricted was not a consideration in Revenue Ruling 79-51. Revenue Ruling 79-51 concluded that the unrealized receivables related to the sale of a partner's entire interest should be taxed as ordinary income under I.R.C. § 751; such conclusion is different from the capital gain treatment under I.R.C. § 731 for the unrealized receivables treated as advances where a partner's interest has not been disposed.

Revenue Ruling 81-241 determined that progress payments, received under a construction contract by a partnership that uses the completed contract method of accounting and subsequently withdrawn by the partners prior to the taxable year in which the contract is fully completed and accepted, are treated as distributions to the partner under I.R.C. §§ 731 and 751. The withdrawals made by the partners exceeded their adjusted basis in Revenue Ruling 81-241. Such fact is consistent with the facts of [redacted]/[redacted] ([redacted]) [redacted] ([redacted]).

The legal analysis of Revenue Ruling 81-241, in pertinent part, is applicable to [redacted]/[redacted] ([redacted]) [redacted] ([redacted]) as follows:

I.R.C. § 731(a) provides that in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.

Subsection 731(d) provides that section 731 shall not apply to the extent otherwise provided by section 751 (unrealized receivables and inventory items).

I.R.C. § 751 (b)(1) provides that to the extent a partner receives in a distribution - (A) partnership property which is - (i) unrealized receivables, or (ii) inventory items which have appreciated substantially in value, in exchange for all or a part of his interest in other partnership property (including money), or (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii), such transactions shall, ... be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

Regulation § 1.751-1(b)(1)(ii) provides that section 751(b) does not apply to a distribution to a partner that is not in exchange for the partner's interest in other partnership property. Thus, it does not apply to the extent that the distribution consists of the partner's share of section 751 property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share. The withdrawals of cash by the partners must be characterized as advances against the withdrawing partner's distributive share of partnership income. As advances, the withdrawals are treated as distributions on the last day of the partnership taxable year with respect to such partner under Regulation §§ 1.751-1(b)(1)(ii) and 1.731-1(a)(1)(ii) and are taxed at capital gain rates under Regulation § 1.731-1(a)(3).

Revenue Ruling 81-241 held that each partner must recognize gain to the extent that the sum of such partner's cash withdrawals in a partnership taxable year exceeds adjusted basis of the partner's interest in the partnership.

Courts have held in various fact scenarios that where the term of the contract extends over a number of years, and the contract may not be terminated at the will of the party for whom the services are to be performed, the right to receive payment upon the future performance of the services will, generally, constitute an unrealized receivable under I.R.C. § 751. U.S. v. Woolsey, 326 F.2d 287 (5^{th} Cir. 1963) (25-year contract to manage an insurance company); Roth v. Commissioner, 321 F.2d 607 (9^{th} Cir. 1963) (10-year contract to receive income under movie distribution contract); and Ledoux v. Commissioner, 77 T.C. 293 (1981), aff'd per curiam, 695 F.2d 1320 (11^{th} Cir. 1983) (20-year contract to operate dog racing track).

The following cases address the tax treatment of unrealized receivables when a partnership is dissolved or a partner's interests are disposed of under sections 731 and 751. The cases all support the determination that the progress payments were unrealized receivables under section 751(c). The cases all support the determination that the amounts in excess of adjusted basis are taxable as ordinary income. As stated above, ordinary treatment is afforded when there is a sale or exchange of the partnership interests and capital gain treatment is afforded when the unrealized receivables are deemed advances and there is no sale or exchange of a partnership interest.

The Tax Court in Wolcott v. Commissioner, 39 T.C. 538 (1962) addressed the federal income tax implications of the dissolution of an architectural partnership with uncompleted contracts. The Court held that the amounts received by petitioner were attributable to his interest in unrealized receivables of the firm within the meaning of I.R.C. § 751 and are taxable as gain on the sale or exchange of assets other than capital assets. The Court's legal analysis included the following: I.R.C. § 741 affords capital gains treatment to the gain on sale or exchange of an interest in a partnership, except as otherwise provided in section 751. I.R.C. § 731 provides that gain or loss shall not be recognized to a partner in the case of a distribution (distinguished from distributive share) by a partnership to a partner except to the extent that any money received exceeds the partner's basis in his partnership interest, and that any gain recognized will be considered gain from the sale or exchange of a partnership interest, but subsection (c) makes the section inapplicable to the extent otherwise provided in section 751. I.R.C. § 735(a)(1) provides that the gain on disposition by a distributee partner of unrealized receivables (as defined in section 751) distributed by a partnership shall be considered as ordinary gain. The ordinary gain treatment based on a dissolution of the partnership differs from the capital gain treatment afforded to advances.

The Tax Court in Glazer v. Commissioner, 44 T.C. 541 (1965), concluded that a partnership in the business of constructing and selling houses which was going to sell the partners' interests when 24 houses were uncompleted was required to report ordinary gain treatment to the amounts received under the uncompleted contracts since the uncompleted contracts were unrealizable receivables under I.R.C. 751. Since I.R.C. § 751 is applicable and the sale or exchange of an interest in a partnership was at issue, capital gain treatment is denied under I.R.C. § 741.

The Tax Court in Logan v. Commissioner, 51 T.C. 482 (1968), held that when a partner sold his interest in a two-man partnership, the cash representing petitioner's share of work in progress was payment attributable to unrealized receivables and taxable as ordinary income under I.R.C. § 751(c). Again, the ordinary income treatment was based on the sale or exchange of an interest in a partnership, not an advance given to existing partners.

The U.S. Court of Claims in Blacketor v. U.S., 204 Ct. Cls. 897 (1974) concluded that with regard to the transfer of interests in a partnership to a corporation, the jobbing contract was an unrealizable receivable under I.R.C. § 751 and any amounts attributable to it would be denied capital gain treatment under I.R.C. § 741.

Based on the foregoing, the [redacted] progress payments received by [redacted] ([redacted]) [redacted] ([redacted]) are not liabilities under I.R.C. § 752; rather they are unrealized receivables under I.R.C. § 751(c). As unrealized receivables, the progress payments should be treated as advances, where the amounts in excess of adjusted basis are deemed current distributions made on the last day of the partnership taxable year with respect to such partner under Regulation § 1.731-1(a)(i) and (ii) and are taxed at capital gain rates under Regulation § 1.731-1(a)(3). Revenue Rulings 73-301, 79-51 and 81-241 should be followed.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

Our office is aware that Letter Rulings are not to be cited by either the government or the taxpayer. Since our research revealed Letter Rulings both in support of the foregoing conclusion and opposed to such conclusion (taxation in year prior to year of completion nullifies the completed contract method election), our office would like to make you aware of the rulings. Rulings in favor of the foregoing conclusion are as follows: Letter Ruling 8648076 (1986) (Rev. Rul. 81-241 is applicable); Letter Ruling 6901020600A (1969) (distributions in excess of adjusted basis results in ordinary gain or loss measured by the difference between its adjusted basis for the section 751 property relinquished in the exchange and the money received by it in exchange for its interest in the section 751 property relinquished); G.C.M. 33948 (1968) (I.R.C. § 752 not applicable, I.R.C. § 751 unrealized receivables result in ordinary income); and G.C.M. 36696 (1976) (gain to the extent that the sum of his cash withdrawals in any partnership taxable year prior to the year in which the long-term construction contract is finally completed and accepted exceeds the adjusted basis of his interest in the partnership).

Rulings opposed to the foregoing conclusion are as follows: Letter Ruling 7611260130A (1976) (since the progress payments received by the Joint Venture in 1971 were not then includible by it under the completed contract method of accounting in computing its taxable income, such payments when withdrawn by its partners are not to be treated as distributions subject to the provisions of section

731 and 751 until the last day of the partnership taxable year in which the Joint Venture includes such payments in computing its taxable income); 1978 Letter Rulings 7848004, 7914009, and 795073 (similar analysis to 7611260130A). Our office has contacted the National Office regarding the foregoing and the National Office has concurred in our analysis and conclusion.

For any questions, please contact Theresa McQueeney, ID No. 11-01914, at (516) 688-1701.

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